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Global Accounting Standards? Not So Fast

Under growing pressure from Europe to jettison certain accounting practices, some fear that investors' interests may not be well served

By David Bogoslaw

The uproar over fair value accounting practices, which some critics have blamed for the depths of the global financial crisis, threatens to sink a long-sought move by countries around the world toward a single set of international financial reporting standards (IFRS). The U.S. Financial Accounting Standards Board (FASB) has been working with London's International Accounting Standards Board (IASB) since 2002 toward what accounting professionals call convergence. The Securities & Exchange Commission (SEC) is expected to announce its road map for conversion sometime this month, which will probably include early adoption in 2010 for about 110 of the largest U.S. companies with business operations throughout the world.

With finance ministers from the 20 wealthiest nations set to meet in Washington this weekend to discuss ways to reform the global financial system, the time seems ripe for a move to harmonize accounting standards (BusinessWeek.com, 11/8/08) across borders, making it easier for investors to compare companies operating in different geographic regions. The major stumbling blocks, critics say, include the IASB's lack of independent funding and its tendency to cave into political pressure.

In October, the IASB bowed to pressure from the European regulators and relaxed its stance on fair value accounting by allowing companies to transfer nonderivative financial assets out of classifications that are reported at fair value into categories that use amortized cost to value assets. IASB rationalized the amendment by saying it would create a level playing field with an existing FASB standard called SFAS 115, which permits companies "in rare circumstances" to make the very same transfer. The IASB argued the current financial crisis essentially qualifies as rare circumstances because of the illiquid marketplace for financial products.

Too Much Interfering

IASB Chairman Sir David Tweedie told a group of British members of Parliament that he considered resigning his post after going toe to toe with the European Commission (EC) over the use of fair value accounting methods and warned that further interference in accounting rules could destroy the effort to adopt a unified set of standards, according to a story in the *Financial Times* on Nov. 12. The IASB reportedly agreed to the change only to avoid a worse alternative—the EC's threat to carve out sections of the IFRS relating to fair value practices.

The CFA Institute's Centre for Financial Market Integrity opposes the IASB's change, calling it a step backward because it doesn't improve the quality of financial reporting. The CFA would like to see a broader

application of fair value into categories where it's currently not required, such as loans and receivables, says Patrick Finnegan, director of the Financial Reporting Policy Group at the Centre.

"If you think we have problems with transparency of balance sheets now, just wait for what's coming [under IFRS]," warns Kenneth Scott, a senior research fellow at the Hoover Institution and a professor at Stanford University's law school. Reclassification of financial assets "doesn't add anything to asset value. It just fixes the books."

It's odd that something promoted as beneficial to investors should be called into question for potentially lowering the quality of reporting standards and in turn, preventing investors from analyzing what a company's assets are really worth.

The key difference between U.S. Generally Accepted Accounting Principles (GAAP) and IFRS is that U.S. standards are based on explicit rules while the international standards' reliance on principles gives companies more room to use their judgment in deciding how to recognize revenue and other key metrics. Adoption of IFRS would also probably trigger a big tax hike for U.S. companies, which would no longer be able to use the last-in-first-out (LIFO) inventory accounting method, which doesn't exist under the international standards. The LIFO method assumes that goods purchased most recently are sold first and that the remaining items have been purchased at earlier periods, yielding a lower gross profit during high-inflation periods than the first-in-first-out accounting method.

Don't Sue Me

The debate over switching to accounting standards based on something less explicit than rules comes down to questions about whether the less explicit standard will provide adequate protection against lawsuits, says James Leisenring, director of technical activities in research at the FASB. "You can't understand the debate about gratuitous vs. obligatory guidance [within IFRS] until you understand the litigation system in the U.S.," where companies are more concerned about getting sued than in other parts of the world, he says. "What it's really about is safe harbors. What [IFRS skeptics] really want to know is 'If I do it in a particular way, am I home free or not?'"

The explicit rules under GAAP may appear to offer safety, but the downside is there are so many of them that the odds of missing one or two are greater, he says. From Leisenring's perspective, the big accounting firms that are drawn to IFRS believe they'll get sued less since it will be harder to point to their mistakes. White agrees that some companies like the freedom allowed under IFRS to interpret standards to suit their convenience, which undercuts auditors' ability to prohibit certain accounting choices.

The most strident critics of migration to IFRS argue that the primary goal of the SEC and U.S. Treasury Dept. is attracting capital to U.S. markets, rather than ensuring that the highest quality accounting standards prevail. While attracting more capital to the U.S. "is a valid business objective, it's not clear we can do that by going to international financial reporting standards," says Ashwinpaul Sondhi, president of A.C. Sondhi Associates in Maplewood, N.J., who has served on CFA Institute committees.

Paul Miller, a professor of accounting at the University of Colorado, would prefer to have competing standards, since the only standards all countries would be able to agree on would be very weak ones. He also believes a unified set of standards, rather than being helpful, would stifle much-needed innovation given that most of the existing accounting standards are more than 60 years old.

Loss of Information

Some investment advisers, including Sondhi, believe investors have already lost valuable information with the SEC's elimination last year of the reconciliation between GAAP and the non-U.S. GAAP standards used in foreign companies' financial reports. "Reconciliation gave me information and told me about [non U.S. companies'] cash flow generating ability that I didn't have from their financial statements alone," Sondhi says.

The fact that many analysts in the U.S. and overseas used to rely on the reconciliation suggests they found the differences between GAAP and foreign standards very useful, says Sondhi. He agrees that competition between different sets of standards might result in better information. "I don't know that either side has achieved a level of standard setting that would lead me to say we can do with one," he says.

Many investment professionals, however, support migrating to a single set of standards, as long as they are of the highest quality. Finnegan at the CFA Institute questions whether the IASB and the FASB can act truly independently given the pressure each has been subjected to by regulators over the past several months as a result of the financial crisis. "When you have that kind of pressure and intervention, you have the possibility of movement to lower-quality standards that's going to appease certain interests at any one point in time, and that's not healthy," he says.

Criticism of fair value accounting has been no less vehement in the U.S. The SEC has resisted pressure to suspend the standard, but Section 132 of the TARP gives the SEC broad authority to suspend the use of SFAS 157 by issuer class or category of transaction (BusinessWeek.com, 10/14/08).

Who Feeds the Watchdogs?

The fact that IASB is funded by corporate contributions also compromises its independence, critics say. Until 2003, the FASB was funded under the same arrangement for 30 years. That changed with the passage of Sarbanes-Oxley, which required the board to be funded by mandatory contributions from the Public Company Accounting Oversight Board (PCAOB), which Congress created to provide better regulatory oversight of the accounting industry.

Miller at the University of Colorado says a better source of funding for a standards board would be stock exchanges, which could charge a fee to buyers and sellers who use the exchanges to do transactions and presumably are users of financial statements. "I would far rather see money going to an international board from users of financial standards than those who prepare them," he says.

Another concern is whether the SEC would continue to have regulatory oversight if U.S. companies adopt IFRS. Says Miller: "The big issue is that sending it offshore diminishes our control, and in a time of crisis where accounting has played a part, I don't think it's especially wise to create a new system that diminishes U.S. control over accounting standards."

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